2
Future of the Economy

China as the next Argentina? For many, that's a preposterous notion. China's economy is the fastest growing in the world, to borrow a phrase that is repeated today like a mantra. But is this true? It certainly was during some times during the reform era. Moreover, it may even have been true, as Joseph Stiglitz has said, that China's economy was the fastest growing in world history.[1]

Experts, most of them foreign, assure us that the People's Republic has a bright future powered by economic growth that is the envy of the world. "The 21st Century will not be Asia's Century, but China's Century," proclaims investment guru Jim Rogers.[2] Some analysts even tell us that the nation will have the world's largest economy in 2010[3] although most predictions of this sort speak of a longer time frame.

Optimism is the consensus view. The picture from Beijing, however, is not so reassuring. Surprisingly, the most depressing assessments come from central government figures themselves, especially those at the top. As noted above, Zhu Rongji, speaking in March of this year at what is probably his last press conference, said that the Chinese economy could have "collapsed" when he took over as premier.[4]

Zhu, attempting to justify his program of increased deficit spending, might have been too dramatic in his choice of words. Nonetheless, he has correctly pointed out that the economy of the world's most populous nation is weaker than is perceived around the world. Similarly, senior central government cadres have been sounding a pessimistic note of late, perhaps as a means of deflating expectations. State Economic and Trade Commission Vice Minister Zhang Zhigang last December stated, "Next year, the economic situation is extremely grave."[5]

So where is the economy headed? As noted in Appendix 1, Credit Lyonnais Securities Asia refuses to release estimates of Chinese economic growth because of the lack of reliable data. Although CLSA's comments are well taken, something needs to be said due to the importance of this topic. We cannot begin to estimate China's capital needs unless we have some idea of the productive capacity of the economy.

Growth forecasts are all over the lot. High estimates from foreign economists fall around 7.5 percent for the current year.[6] The most authoritative of the official ones come from Premier Zhu, who at his recent press conference said that the country will meet the nation's 7 percent target. It is improbable that Beijing will ever announce numbers showing that growth has fallen so much that the country will not meet that goal for the current five-year plan.

Despite their unreliability, official numbers provide clues as to what is happening in the economy today, at least regarding overall trends. Figure 2.1 shows announced GDP growth for the last five calendar years (1997-2001).

Figure 2.1
Announced Percentages of GDP Growth
1997-2001

1997	1998	1999	2000	2001
8.8	7.8	7.1	8.0	7.3

source: China Statistical Yearbook 2001
People's Daily Online

As these figures demonstrate, growth is definitely heading downwards. The results for 2000 stand out as they disrupt the trend. In that year we witnessed a sharp upward spike in growth of gross domestic product. Perhaps the 2000 figure can be explained by the phenomenal growth in exports of 27.7 percent in that year.[7] Nonetheless, the economic lift provided by exports was blunted by the 35.7 percent increase in imports.

Other factors cast doubt on the accuracy of the 2000 results. For instance, the poor GDP numbers for 1999 and 2001 look remarkably alike. More damning, however, are deflation figures. China allegedly moved from deflation to inflation in 2000, but the result was largely reversed in 2001. The results for 1999 and 2001 resemble each other closely with respect to both GDP and deflation, and this similarity at least suggests that the strong numbers for the middle year of 2000 were the product of political edict rather than honest statistical tabulation. "The figures are so good, I just cannot believe them," said a Chinese bank economist in the middle of 2000. "How can things turn around so quickly?"[8]

The trend of slowing growth is even more evident if we go back further in time. The large jump in GDP in 2000 was a reversal of the tide of seven years of declining growth rates. GDP growth in 1999 of 7.1 percent was half the rate of 14.2 percent achieved in 1992.[9] In the past decade China has experienced all sorts of economic conditions, but one thing has remained constant: in periods of inflation and deflation and slowing investment and growing investment, the increase in China's GDP slowed.

The downward trend continues today. Little noticed is the fact that China's GDP grew by only 6.6 percent in the last quarter of last year.[10] That figure significantly demonstrates deceleration from the overall rate of 7.3 percent claimed for 2001.[11] Growth slowed from quarter-to-quarter last year, so senior cadres cheered when they announced that GDP for the first quarter of this year was up: 7.6 percent.[12] What isn't widely known is that the 7.6 figure is a half point less than growth for the same quarter last year.

Senior political leaders and technocrats are in a tizzy about declining GDP growth rates. These rates, albeit lower than before, are extremely high by world standards. Why do Chinese leaders think that this is such a dreadful state of affairs? Why do they have a high growth policy in the first place?

Beijing has wisely opted for reform of the economy. Although the leaders of the People's Republic were, and still are, haunted by the specter of social instability, they did extremely little to relieve the social pain resulting from transformation of Mao's highly rigid economic system. There was, if the truth be told, plenty of opportunity to develop a social safety net, but, falling back on one strain of Maoist thinking, they decided to grow their way out of problems. Chinese leaders, as we can see, are fond of building things, and they apparently thought that building even more things was their solution. The unfunded pension and social security crisis, described in Appendix 3, is the result of this flawed approach.

Accordingly, in the late 1990s in Beijing it became an article of faith that the economy, as measured by gross domestic product, had to grow by at least 8.0 percent in order to absorb the newly unemployed and those entering the workforce for the first time. To achieve that goal the central government used fiscal stimulus, spending. Despite all that they did, the economy was not able to expand at that rate on its own. So now, as noted above, we hear that 7.0 percent is the magic figure. The consequence of inefficient spending is slowing growth, and Beijing's response to slowing growth is, unfortunately, more state spending.

Yes, China needs growth. Yet, more important, China needs good quality and sustainable growth to provide for those disadvantaged by the ongoing reform of the economy. The country endured massive worker protests in Daqing and Liaoyang in March and April of this year as well as the scattered demonstrations that took place in other parts of the country during this period. The People's Republic, as a matter of the highest priority, has to create more jobs to avoid tomorrow's Daqings and Liaoyangs because social stability is essential to ensure the continuation of the reform process.

Today's growth, fueled by government spending, is not sustainable. Unsustainable growth is a disease that ultimately killed the Soviet Union, and it is now afflicting China as well. As author Joe Studwell says, the Soviets could launch Sputnik[13] and impress the world. Today, the People's Republic seeks to dazzle us with its space program and all its other projects, but it must not forget that it must develop an economy based on sound fundamentals. So far, it is not meeting the challenge. In polite language the Organization for Economic Co-operation and Development, the Paris-based club of developed nations, tells us: "China's economy is clearly operating below its productive potential."[14] Extrapolation, if nothing else, indicates that growth numbers will continue to decline during the balance of the current five-year plan (although, as mentioned above, Beijing will not permit released figures to average below the 7.0 percent target set at the beginning of the plan as that would be considered politically unacceptable). So is there anything that will halt the slide? The main candidates are 1) accelerated reform of the economy and especially the beneficial effects of membership in the World Trade Organization, 2) an improving world economic environment, 3) increased foreign investment into China, 4) effective utilization of domestic capital, 5) state stimulus, and 6) an adjustment of the currency.

First, how much will economic reform aid GDP growth? The People's Republic achieved fabulous--and real--growth as the byproduct of dismantling the Maoist command system. The economic theories of the first leader of New China resulted in one of the most inefficient economies the world has ever seen. Productivity gains came easily as Beijing implemented all sorts of reforms and as the Chinese people themselves went about bettering their own lot with--and often without--government approval.

One of the largest population shifts in the history of the world, from countryside to city, gave China an enormous one-time lift in GDP. That migration continues, but it is reaching its end: most of the gains have already accrued. Cities are already reluctant to permit the influx of additional migrants as the ongoing national debate over the household registration system demonstrates. So, for the most part, further progress will come through painful restructuring. Painful restructuring, except that forced by accession to the WTO, is unlikely during the next few years, however.

We often think that China's leaders have chosen economic reform. As a general matter they have, but at the same time they have not lost their faith in their ability to plan in five-year blocks of time. The continued emphasis on planning is inconsistent with market reforms, but the phrase "socialism with Chinese characteristics" is not code for capitalism as many foreign experts believe. It is an attempt to find a middle way.

Senior Party leaders and the Beijing bureaucracy refuse to give up their hold over the economy. They try to manage competition, pick winners, and insist on making all but the smallest of decisions.[15] It is believed, for instance, that Premier Zhu Rongji personally chooses which foreign investment banks get mandates for initial public offerings of stock of state enterprises.

Beijing has created a semi-market economy to operate in a communist system. The OECD reminds us that this effort has been highly successful, but it is becoming "increasingly apparent that its ability to push China's development further is coming to an end."[16] "A short period of success is often followed by disasters that last longer."[17] Morgan Stanley economist Andy Xie, referring to Chinese history, tells us that backsliding is not out of the question.

Chinese workers know that's true. Recent large-scale worker protests across China, and especially those in the northeastern rust belt cities of Daqing and Liaoyang, highlight the problems in the economy and suggest that Xie might be prophetic. To some, the massive disturbances may mean that China must push forward with reforms, but to others, and especially those in senior Communist Party circles, they highlight the dangers of letting economic forces reshape the economy.

Beijing's technocrats may subscribe to the concept of creative destruction, but most of their political masters in the Chinese capital do not. There are factions that believe that nothing should be destroyed, and there are those who think that the state should not take risks in the immediate years ahead. In a leadership that largely operates by consensus, the reformers will have to cool their heals for the moment. All the turmoil on the streets and in Zhongnanhai means that important reforms will remain on the back burner for the next few years. And that means the economy will not benefit much from structural reform during the current five-year plan. Today, change of that sort would strike at the heart of the socialist system. At present, there is no political will for that kind of progress.

Progress means the further erosion of the dominance of state enterprises, and that concept is still unpopular in many quarters in Beijing. As Thomas Byne of Moody's said in his testimony before the Commission in December, "The imminent demise of the state sector in China I think is exaggerated." Unfortunately, he is right. Today, stagnation is evident in much of what Beijing does, or doesn't, do. For example, last October the People's Supreme Court, China's highest judicial tribunal, ordered provincial courts to halt most bankruptcy proceedings involving state enterprises. "Capitalism without bankruptcy is like Christianity without hell," said one economist.[18] Because few in the People's Republic can enter the underworld, the reform of China's bloated public sector is once again on hold. Even China bulls know that the years ahead will be difficult. "The heavy lifting in China is now beginning," writes Morgan Stanley's Stephen Roach.[19]

Many analysts say that Zhu Rongji is using accession to the World Trade Organization to force change in the Chinese economy. Will it do so? Membership, at least in an ideal world, should cause substantial transformation in the economy as the stagnant state sector sinks and the vibrant private one grows, aided by all the foreign investment attracted by accession. Yet those who argue that such change will occur fail to take into account politics. Beijing will do its best to prevent change from happening during the current five-year plan.

Beginning later this year and continuing into next, almost all the top posts in the Party and the government are supposed to change hands. In Communist party terminology, the Third Generation leadership makes way, or doesn't, for the Fourth. Neither of the two prior transitions in the history of the People's Republic went according to plan, and there's no reason to believe that this one will be any smoother (especially now that the Party is already split over various issues and especially because Jiang Zemin is maneuvering to retain as much power as he can). So when the challenges to China will be the greatest, the regime will be at its weakest.

Wang Xiangwei, China editor of the influential *South China Morning Post*, points out what should be obvious to China watchers: the political transition will result in the postponement, or at least the slowing down, of economic reforms.[20] In a period of political struggle, it will be difficult for untested and insecure leaders to undertake what Jiang Zemin and Zhu Rongji were unwilling to do in a more peaceful period: force structural change in the economy by taking on vested interests, reordering priorities, and risking social instability.

Andy Xie, in arriving at his optimistic conclusions, lists risks and dismisses them, but he does not analyze the most common one of them all: stagnation caused by political transition. He says, in passing "The current leadership succession appears to be taking place peacefully."[21] Peaceful it will be, but that's not the point. Succession will not result in deaths and beatings in this kinder and gentler era. The risk is that China will waste even more time on the road to reform that must occur. That appears to be happening already, at least judging from the last National People's Congress meeting. In a period of economic troubles, almost nothing, even less than usual, happened at the big conclave. The story is that there was no story.

Beijing can slow reform, but it cannot prevent change. Senior cadres simply cannot divert the inevitable forces of history. The economy is now out of the leadership's control, and, due to WTO, they cannot rein it back in. Relatively unrestricted economic warfare will change the face of much of the nation's economy.

Yet change need not necessarily be for the better, at least at first. "I always maintained that WTO accession would bring us both advantages and disadvantages," Zhu Rongji said this March. "But since the beginning of this year, there have been no advantages, only disadvantages."[22] And Zhu's assessment is not surprising. Jiang Zemin opted for gradual change in the run-up to accession, shying away from structural reform as much as he could. As a result, China's economy is generally unprepared for the competition that WTO is now bringing to China.

Experts who tell us that WTO will increase China's GDP talk about the long term. The People's Republic could be a beneficiary of joining the global trading organization, but the benefits only come later after structural reform has had an opportunity to take effect. In the first few years the country will experience pain: more business failures, more layoffs, and (as we have already begun to see) more social unrest. That's inevitable--China is trying to cure more than five decades of economic mismanagement with the shock therapy of WTO.

Early experience shows that foreign products and raw materials are already flooding the Chinese markets.[23] That has to reduce China's GDP as we see the reverse of "import substitution." Multinationals always need to increase their markets, and the most likely place to do that is the only significant new source of buyers on the planet, China. A journalist bored by the uneventful National

People's Congress this March was much more interested in reporting that in the street stalls of Beijing near the meeting Australian oranges were crowding out ones grown in the Ganzhou area of Jiangxi Province.[24] Over time, more foreign goods and produce will dominate local markets.

On the other side of the coin, WTO means that exporting will be harder than in the past: China has to give up its generous export subsidies. Economists debate how much these really help, but common sense says that they must have some effect. China could have a trade deficit of US$10 billion next year, says Zheng Jianmin, an economist with the University of International Business and Economics.[25] Officials agree on the trend. Bai Hejin, president of the Macroeconomic Research Institute under the State Development Planning Commission, says that eventually WTO means that a trade deficit "will emerge."[26] That's not the only deficit that might come into view. *People's Daily* has reprinted comments of a Solomon Smith Barney analyst that WTO will move the country into a current account deficit by the end of the current five-year plan, and maybe even this year.[27]

And it is not only the flows of goods and produce that are being affected by accession. Mainland experts were stunned by the news that Swedish multinational Ericsson had paid back almost two billion yuan in loans to three local banks and transferred most of its business to foreign ones. "The Ericsson case is evidence that the impact of WTO on our financial sector is far faster than anyone had imagined, bringing problems that people had not anticipated," says Li Yang, director of the China Finance Research Centre at the elite China Academy of Social Sciences.[28] "The [five-year] transition is not a period of safety and competition does not wait until you are ready for it."

Despite what Premier Zhu says, there are definite benefits to WTO membership. Obviously, WTO can increase growth by increasing exports. China's lengthy accession protocol both opens global markets and guarantees long-term access to others that were relatively open before accession. As an example of the latter phenomenon, some, such as analysts at the U.S. International Trade Commission, believe that China's favorable trade balance with the United States will grow even larger in the future as the new trading giant displaces other exporters around the world.[29] The process of displacement is already occurring.

There is, however, a limit to how far China may go in penetrating world markets. There are two primary concerns. First, world trade fell last year, says the organization that should know, the World Trade Organization. It was the worst drop since 1982.[30] China did relatively well in this environment, but the country cannot power its economy with exports while global commerce falls.

Second, China faces special roadblocks. Nicholas Lardy's *Integrating China into the Global Economy*[31] does a fine job in detailing the changes that have occurred since 1978 in the People's Republic and argues the country should prosper now that it has entered the global trading body. Yet Lardy also points out that, in order to gain admission, the country agreed to "WTO-plus commitments," which give the United States and other nations unprecedented rights to keep Chinese goods out of their markets. Whatever one may think of the fairness of these protectionist measures (and Lardy convincingly shows us that they are not fair), they can nonetheless stop China's export machine in its tracks.

So the Chinese government today is worried about a "new tidal wave of trade protectionism."[32] This is not some theoretical concern: the People's Republic is now involved in at least a dozen new disputes from steel[33] to sausages[34] with both developed countries and emerging ones. For example, the European Union banned imports of a wide range of animal products from China earlier this year[35] and other countries followed suit.[36] China and the Netherlands are engaged in a tit for tat spat over food safety as they destroy each other's exported products for health reasons.[37] Additionally, China claims that it suffers more than any other nation from anti-dumping suits, 500 of them filed by 30 countries.[38] That is one central government claim that can be believed. Moreover, China has just learned about the importance of the environment as it now faces "green barriers."[39] For every action there is a reaction, and in the trade area that means China's exporters will have to overcome hurdles before they finish their conquest of world markets.

So far, we have seen profits of state enterprises decrease[40] and prices of domestic goods tumble.[41] China was already in a mild deflationary period,[42] and the first three months of this year, the first quarter after accession, saw consumer prices decline by 0.6 percent. The trend downhill is picking up steam: the fall in March was even greater (0.8 percent year-on-year).[43] Deflation is not surprising. The Chinese people do not feel comfortable in spending in such a period of uncertainty. In essence, they are casting a big vote of no confidence in a country where no confidence votes are never formally taken. The victim of this caution is the overall health of the economy, because many economists agree that any recovery must be led by consumers.

Accession may be the savior of the Chinese economy in the long run, but the effect during the Tenth Five-Year Plan, the current one, is, and will be, not so good. Joining WTO will not add one or two percent to GDP growth right away as some tell us. If anything, the reverse is true. Daryl Ho of Hong Kong estimates that joining WTO will reduce the growth rate by 0.8 percent per year over the near term.[44] We can already see what the short-term effects of accession are.

Second, will a rising world economy rescue China? Most probably. The People's Republic was unlucky. America was not the only victim of September 11. Last summer it was clear that the world's developed economies were heading into a coordinated recession. We could see evidence of that here in North America, in Western Europe, and even in Asia. That was bad, but then those horrible attacks in New York and Washington occurred.

In reaction, consumers around the world pulled back fast. As they did so, even China's low-end exports, once thought to be impervious to downturn, suffered as markets shrank. The People's Republic entered the WTO at the worst possible moment in its 15-year quest to become a full-fledged member of the global trading community. China joined the WTO, and therefore the world, just as most of the world's economy stumbled.

China had long denied that a slowdown in its foreign markets would have much an effect on its economy. In the middle of last fall, however, the leadership in Beijing and official media begun to recognize the dimensions of the problems they faced. Jiang Zemin acknowledged in October the gravity of the situation when he referred to the economic fallout of the September 11 attacks: "All this has made an already grave economic situation worse."[45]

In retrospect, that statement was overly negative, but Chinese exports took a hit nonetheless. Export growth fell from 2000's phenomenal 27.7 percent to single digits, 6.8 percent, in 2001.[46] Last year was the third straight year in which China's trade surplus declined. We have to look back to 1996 to find a smaller surplus than the one last year.[47]

Export growth has recently recovered (as exports did in the other powerhouses of Asia). Figures from the first quarter of this year show that exports increased by 9.9 percent year-on-year.[48] Yet it is too soon to break out the champagne. State officials still call the export situation "grim" despite the good start to the year.[49] And they were right to be concerned because it is much too soon to conclude that the rebound will last. Export growth in March was only 3.4 percent.[50] *The Wall Street Journal*, stating the obvious, called this "an abrupt slowdown."[51]

Now trade officials are playing down an export rise, predicting zero growth. "The slowdown in global economic growth has more negative far-reaching effects on China's exports than the 1997 Southeast Asian financial tumult," says foreign trade Vice-Minister Zhou Keren. "It's now more difficult to predict where the world economy is heading than at any time before."[52] China, now a major exporter, is benefitted--and harmed--by economies around the world.

America's economy, and economies around the globe, are just regaining their health. Consequently, China's export machine will not pick up until late this year or early 2003 (due to the roughly half-year lag for economic conditions in importing countries to affect exports). But if there is a "double dip" recession in the United States as some forecast[53] or a lackluster recovery, the rebound in China will be further postponed. Nonetheless, there will be recovery well before the end of 2005.

Figure 2.2 contains predictions of Chinese export growth throughout the period covered by this report. Exports will not contribute much to the economy until the end of this period. With imports increasing at a faster pace, we will see trade deficits soon, probably beginning in 2004.

Figure 2.2
Estimated Percentages of Export Growth
2002-2005

2002	2003	2004	2005
6.2	5.8	5.9	6.3

Third, will increased foreign investment into China hold out real prospect for growth in output? As noted above, the People's Republic is already benefitting from the process of displacement. If the world's press is to be believed, the world's manufacturers are all moving to China. Last year saw record foreign investment into the country: Beijing claimed that actual (as opposed to contracted) foreign investment totaled a record US$46.8 billion, up 14.9 percent from 2000's total.[54] Continuing the trend, actual FDI was up an incredible 27.5 percent in first quarter of this year.[55]

The foreign investment picture, however, needs to be put in context. For one thing, the large increase in 2001 is off a low base. Foreign investment declined 11.4 percent in 1999 and was essentially static in 2000.[56] The record amount of 2001 was only 2.9 percent more than the corresponding figure for 1998 of US$45.5 billion.[57] In other words, foreign investment has just recovered from its previous level as illustrated in Figure 2.3.

Figure 2.3
Actual Foreign Direct Investment
1998-2001
(US$bn)

1998	1999	2000	2001
45.5	40.3	40.7	46.8

source: Finance Yearbook of China 2001
China Statistical Yearbook 2001
People's Daily Online

This year another record could be set, at least according to Chinese government officials, who foresee investment approaching US$50 billion.[58] But the officials are real pessimists compared to the foreigners. Some of them talk about foreign investment at US$80 billion a year and others even see US$100 billion, yet China will not attain such levels, except perhaps in the imaginations of overheated observers.

Foreign investment received a big push in the last few years because of all the optimism that surrounded China's accession. The People's Republic benefitted from WTO membership, some argue, well before joining, perhaps two years before. At the time of the U.S. agreement with China in 1999, substantial flight capital returned to the Mainland in the form of "foreign" investment in order to take advantage of preferential taxation and other benefits. Most of the funds came back through Hong Kong, the way they left in the first place.[59] At least 20 percent of the total amount of FDI is "round-tripped."[60]

Although FDI should increase this year, the trend will change for various reasons. As an initial matter, the rush of investment after accession will naturally tail off. Moreover, investment was premised on a stable and growing China. Now the glow is fading: analysts and commentators are beginning to see the serious problems plaguing the economy. Even the American Chamber of Commerce, traditionally China's biggest booster outside the Communist Party, is starting to turn cautious about prospects for the economy and, consequently, further investment. AmCham warns of many risks a nd then

notes that “many foreign companies are tightening their capital budgets.”[61]

Moreover,

the recent tide of industrial protests across the country is beginning to reduce

some of the

“irrational exuberance,” to borrow a phrase from another context.

More important than changing perceptions about China is the glut in industrial capacity. Those who say foreign investment will continue to mushroom are ignoring the realities of China and the world at large. China is suffering from overcapacity in every major market segment except perhaps for telecommunications. “There is not a single major product that is in shortage,” said National Bureau of Statistics Deputy Director Qiu Xiaohua last month. “They are either in excess supply or stable.”[62]

Overcapacity in China is matched by overcapacity in the world today. If you are a manager for a multinational in China, you will want to build bigger facilities to take advantage of the emerging national marketplace. But if you are an executive in London, Paris, or New York, you will want to export to China from underutilized factories around the world. WTO means that tariffs are dropping and local rules against distribution are lapsing so that exporting to the Mainland will not only be a feasible solution but also the compelling one.

Will foreign investment increase this year? Yes, it will. But in all probability the increase will be smaller than predicted and the boom will be shorter than expected. This prediction is more or less in line with that of the American Chamber in Beijing, which sees no or almost no increase in foreign investment this year. “We expect that foreign investments will be at the same level in 2002 or even slightly lower than in 2001,” says Kim Woodard of AmCham.[63] Even state media is carrying talk of a decline in foreign investment.[64]

And even if China can manage 20 percent growth per year in foreign investment, the effect will not be large. Increases of that magnitude would add just one percentage point to GDP growth.[65] When foreign investment declines, growth will tend to slow even more.

Figure 2.4 contains this report’s predictions for foreign investment through 2005. There is a moderate decline in investment starting from next year and continuing throughout the remainder of the current five-year plan. As China’s social and economic problems become more evident, nervous managers in home offices will rethink their investment plans.

Figure 2.4
Estimated Actual Foreign Direct Investment
2002-2005
(US$bn)

2002	2003	2004	2005
53.8	51.1	43.4	35.5

Fourth, can China’s domestic capital produce growth? Some economists argue that encouraging foreign investment, especially at this time, is not the right strategy because domestic private businesses suffer. Moreover, foreign money, channeled by the central government to large state enterprises, supports the least viable sector of the economy.[66]

China’s own economists rightly point out that, based on the numbers, the nation has plenty of domestic capital for its own needs. Qiu Xiaohua of the National Bureau of Statistics backs them up: he has estimated that the country has about US$1.2 trillion in hands other than the government. Included in this amount are the savings of ordinary Chinese. At the end of 2001, household savings, according to official statistics, amounted to the equivalent of US$894.1 billion, up 14.7 percent[67] from the year before and 24.0 percent from 1999. At the end of the last quarter, the figure was an even more staggering US$954.1 billion,[68] a jump of 6.7 percent in just three months. Moreover, the country is not lacking in foreign currency savings. Individuals held at the end of last year US$81.6 billion in forex deposits.[69] Total forex deposits were perhaps as much as US$135 billion.[70]

In general, the Chinese call their savings “the tiger in the cage.”[71] If the tiger were to roam (in other words, if China's savers were to withdraw savings from the banks), domestic demand would stimulate the economy. The creation of such demand has been one of the goals of Premier Zhu Rongji, who tried to draw in China's savers into the equity markets in the last part of the 1990s in a misconceived and poorly implemented campaign.

China's economists have a better plan. In the words of Professor Song Yi, research fellow of the Economic Research & Consulting Center under the State Economic and Trade Commission and vice chairman of the China Development Strategy Institute, "Domestic private investment should be granted the same treatment as foreign investment." Song says domestic savings have become a "burden" for the banks.[72]

All such plans to free the tiger share one fatal flaw, however. The banks need the liquidity provided by China's savers, as described in Appendix 2. On occasion the state tries to encourage savers to take their money out of the banks for one purpose or another, yet it cannot afford to see significant withdrawals from these financial institutions. Because the tiger will stay where it is until the banks are fixed, domestic capital will not provide much help in stimulating the economy during the current five-year plan.

Fifth, will state stimulus save the economy? It certainly is weakening the financial condition of the central government, as noted above. But is stimulus effective? You are left in no doubt if you listen to senior cadres. Fiscal stimulus, Finance Minister Xiang says, contributed 1.8 percentage points to growth in 2001. That's on top of the 1.7 percentage points in 2000, and 2.0 percent in 1999.[73]

Stimulus may have worked to keep growth going, but it has created it own problems. Now an addict, China's economy is hooked on infusions of central government cash: "state spending plays a critical role in keeping the economy afloat," says noted analyst Andy Rothman of Credit Lyonnais Securities Asia.[74] The figures show the extent of the addiction to steroids. Fixed asset investment, made predominately by state enterprises,[75] was up 26.1 percent on year in the first quarter.[76] First quarter GDP growth was, therefore, clearly the result of such investment, which was applied earlier this year than in previous ones.[77]

All in all, fixed asset investment accounts for about 40 percent of China's GDP while it should be much lower, a third or less.[78] Today the central government accounts for about two-thirds of total investment in the country, a situation that is "alarming."[79] Something else that is alarming is the declining efficiency of the government's stimulus program. The growth of fixed asset investment, for instance, is way above that for GDP.

It is not hard to see why spending is starting to lose its effect. Infrastructure may, and probably will, benefit the economy tomorrow, but unfinished buildings[80] and deserted roads don't help today. Worse, the central government must find some way to begin paying for them now. China can pump up its GDP with unsalable inventory, but, apart from temporary job creation, that exercise is economically useless. Another reason for the declining effectiveness of the stimulus program is that some money is leaking out of the system in the form of corruption. No wonder domestic economists are saying that the return on state spending is dropping.[81] "China's growth is highly inefficient," says Morgan Stanley's Andy Xie. "It costs five dollars of investment to generate one dollar in growth."[82]

There is an inherent problem in Zhu's "spend until the end" program. Professors Zhu Xiaodong and Loren Brandt of the University of Toronto argue that China's growth is stagnating "because of a sharp reduction of investment growth in the non-state sector." This reduction has occurred because, among other reasons, massive government spending has even further reduced credit available to non-state businesses.[83]

Zhu's plan means massive amounts of money are being poured into the state sector with little or no return. Yet support for SOEs is "one of the world's most grotesque misallocations of credit."[84] There are essentially two economies in China, a stagnant state one and a vibrant private sector. Most of today's growth exists because of the private one, everyone agrees. So Beijing is crimping the one dynamic part of the economy. Economists around the world, including economists in China, point this out to Party leaders, yet they cannot abandon the old emphasis on development and growth of state industries. In the late 1990s Zhu choose infrastructure spending instead of structural reform, and now the Chinese economy is paying the price.

The state, not surprisingly, has chosen to help the state sector as it seeks to restart the economy. Wing Wu, the head of Beijing-based China Chengxin International Finance Rating Company, says, "They know they need to continue to pump-prime the economy and although they agree that this might not be the best way to do it, they also understand that it is the only way."[85]

It is not the only way, however. If Beijing wants to stimulate the economy, it should put--or leave--more money in the hands of China's ordinary citizens. Premier Zhu, however, has ruled out a tax cut to boost the economy.[86] Government officials say they want to boost consumer demand, but they continue to take money out of the hands of consumers. Consumer demand is what will pull New China out of its new economic problems, but incomes must rise before that happens.[87]

Leaving money in the hands of ordinary citizens might be the only way because monetary policy does not offer much hope, at least as long the state continues to severely restrict credit for private businesses. Interest rates, for instance are already low. The interest rate cut in February of this year was the eighth straight reduction in rates. China, in the words of Andy Xie, is "running out of room to stimulate."[88]

Even though state leaders know that their policies are not working well, they do not appear to be in any hurry to discontinue them. On the contrary, we will probably see fiscal stimulus in some form throughout the balance of the current five-year plan. The political costs of ending the state spending spree are too high. At this stage, the technocrats have not yet figured out what else they can do within the tight political restraints under which they operate. As long as there is substantial unemployment--and its twin, underemployment--there will be spending by the state.

Unemployment, already severe, will get worse in the next half decade (Appendix 3), and China's leaders are just beginning to come to grips with the "grim job situation."[89] As state media tells us, in the next four years "China is likely to experience the most serious unemployment pressures it has ever faced."[90] In this environment, the government will not give up short-term fixes provided by doling out state cash. No matter how much they weaken the nation's finances.

And no matter how unsustainable they may be. China has avoided a recession during the Zhu Rongji era, and fiscal stimulus is the premier's tool for avoiding one now. But all economies go through cycles of growth and contraction. Government officials around the world try to even out the highs and lows, but they cannot avoid them altogether. No government, no matter how many resources it has at its command, can put off the inevitable.

In China now the long-term trend for growth is down, and eventually there will have to be a recession. The longer Zhu puts off a contraction, however, the worse it will be. The premier, therefore, is only making the next downturn severe. He cannot have what no one else has been able to manage: growth all the time. That is simply not possible. Consequently, Beijing has to spend more and more to prevent what economic science, or human behavioral patterns, say must happen. His attempt may be noble, but it is not only expensive but futile.

Sixth, will China adjust the value of the renminbi? And if it does, will this drastic tactic work? Although the central government is running out of ways to keep its economy going, there is always the nuclear option: the classic maneuver for a government in trouble is the devaluation of its currency. A couple months ago, talk of an impending devaluation would have sounded irresponsible. Today, doubts about the currency's strength are beginning to surface.

Beijing has long pledged to keep its currency stable. The renminbi floats, but that's only true as a technical matter. The float is tightly managed so that the rate stays close to Rmb8.28=US$1.00. The yuan, another name for the renminbi, is convertible only on the current account although there have been periods, especially during the forex crackdown beginning in 1998, when current account dealings were effectively at the discretion of officials. Technocrats and political leaders are loath to let go of the currency. Their control over the renminbi effectively gives them control over much of their economy.

In the past, China received kudos for making sure that the value of the yuan did not budge. Premier Zhu won plaudits, and Asia's appreciation, by defending the yuan during the Asian financial crisis of the late 1990s. Today, however, there is a different story.

If allowed to float, China's currency would probably appreciate. That is why

Zhu is now being criticized for keeping the renminbi low. Other countries would like to see a free float to make their own exports more competitive.

From China's perspective, there has already been a recent appreciation of the renminbi. In the good old days before joining the World Trade Organization, China doled out generous subsidies to exporters. These incentives are on the way out, if not already eliminated, because of accession. For the leaders in Beijing, the new rules feel like an appreciation of the currency. But other countries want China's exports to be even less competitive through a floating of the renminbi. Japan took matters into its own hands recently and let the yen fall.

Yet Beijing is under pressure from forces other than greedy governments. Now the International Monetary Fund has gotten in on the act. China should consider a more flexible exchange rate, says the IMF.[91] Chinese leaders are not so sure. "This policy will not be changed," says Zhu Rongji, referring to China's policy of maintaining the value of the renminbi.[92] Today, there are many reasons why the government wants a stable currency. Perhaps the major risk associated with downside movement is stopping the flow of foreign investment into the country.[93]

Yet as the economy declines, Beijing may have no choice but to allow the currency to float downwards--or by edict fix a new value. Already there have been hints that the currency will go lower. For instance, Dai Xianglong in March of this year was making comments that the weak yen was putting pressure on the renminbi.[94] Why would an export powerhouse like China complain so bitterly this year about Tokyo allowing the Japanese currency to find its own levels on world markets? Moreover, Dai's recent comments in Tokyo about using a basket of currencies instead of just the dollar to fix the managed float is the first step on the road to devaluation.[95] The central banker has hinted that a floating foreign exchange rate is on the way,[96] but we have heard words like this before. So it's time to wonder whether this time he was being sincere.

Sincere or not, Chinese policy makers are at least worried. Last November saw the opening of the new gold exchange in Shanghai. Normally state media would mark the end of a five-decades old monopoly with fanfare, but the event was "low-key," in large part because of "official nervousness" about letting market forces taking control of trading in a commodity that could be used as a hedge against a depreciating currency.[97] Beijing has tried to shut the door on any talk of a devaluation, but domestic economists nonetheless discuss the issue in light of the ongoing decline in export growth. For instance, Zheng Jianmin, the economist with the University of International Business and Economics, argues that now is a good time to send the renminbi lower because of the bad trade trends. In his view, a devaluation would work because the nation can afford to pay its external debt from its foreign currency reserves.[98]

If there is a devaluation, the percentage drop will be big: probably on the order of 20 to 25 percent. A smaller decline would not have much effect. The most probable time for a devaluation would be 2004 or 2005, after China has run out of other options.

A devaluation never solves the structural problems in an economy--it can only buy time. The problems in China's economy are intractable. It is unlikely that even a large depreciation in the yuan will have much effect in the long run, especially because China's trading partners would, and probably will, retaliate with competitive devaluations of their own. From a long-term perspective, the renminbi has decreased in value, and that trend will continue during the current five-year plan.

A devaluation, no matter how implemented, will just push back a decision to make China's currency convertible on the capital account. The easiest way to be wrong about China is to predict the date of such event. A history of bad predictions does not stop the analysts today: "Since China is in the WTO, eventually the currency has to be convertible," says Frank Gong, senior currency strategist at Bank of America in Hong Kong.[99] That assessment may be true, but this report predicts that such convertibility will not occur during the current five-year plan. In a period of economic stress, Chinese leaders will not give up this important control.

The risk is that China delays devaluation for so long that it finds itself in the same position as Argentina, a possibility raised by Secretary of the Treasury Paul O'Neill in his testimony at the beginning of this month before the Senate Banking Committee. He said that the People's Republic, even with all its reserves, could not keep the peg in place.[100] O'Neill is right, but we know that China will try. Today Chinese central bankers talk about using the enormous foreign exchange reserves at their disposal to keep the yuan stable.[101] If the central government perceives that China's reputation is at stake, it may do everything possible to keep the yuan high. And wait much too long to devalue.

As mentioned above, China's economy is on a long-term path to low growth. None of the items discussed above--accelerated reform, an improving world economy, increased foreign investment into China, effective utilization of domestic capital, state stimulus, or an adjustment of the currency--will be enough, either by itself or in combination with the others, to materially boost the economy.

There are, however, problems that will plague economic growth in the years ahead. First, the environment will either degrade or absolutely block economic activity in parts of the country. Some people believe that the water shortage in northern China will cause the worst known environmental disaster in the history of the world. Whole cities and towns may have to be abandoned, according to experts. The enormity of the Yangtze River diversion project testifies to the potential seriousness of the situation. The People's Republic can poison its air, soil, and water for only so long.

Second, the lack of jobs threatens social stability. The rate of registered unemployment in the cities was 3.6 percent in 2001.[102] That is up from 3.1 percent, the rate that prevailed for the four-year period from 1997 to 2000.[103] These statistics, which could be accurate because of exceedingly technical definitions, understate the severity of the situation. Many believe that the real rate of urban unemployment is around 20 percent. In Liaoyang in Liaoning Province, the rate is said to be at least 60 percent. In December of last year the Ministry of Labor estimated that the country would have to create eight million new jobs to prevent the urban jobless rate from exceeding 4.5 percent.[104] Just think how many jobs the government really needs to create to deal with *all* the unemployed in the cities.

Urban unemployment, however bad, is not the worst problem. "If you are talking about one single issue that gives me the worst headache, that topic is how to increase the income of Chinese farmers," said Zhu Rongji this March, using the politically correct term for peasants at his press conference. "China has at least 200 million more farmers than it needs for efficient agricultural production," writes CLSA analyst Andy Rothman.[105] Beijing's good intentions need to be translated into sound policy in the countryside. Leaders talk about these problems year after year, but relatively little is achieved--that's why peasants talk about "slogan agriculture." The nation's leadership has yet to prove that it has the ability, and the will, to tackle these problems.
The situation is clear. China needs more jobs,[106] and now it is not creating enough of them.[107] Most important, it needs them now: workers and peasants are increasingly impatient.

Third, although China has urgent economic problems, the People's Liberation Army will obtain bigger and bigger slices of the central government's budget. That is natural in a time of political transition when the support of the PLA, a large power bloc in the Party, will be crucial. For the last few years it appears that the rates of budget increases for the military were more than double the rates of growth in output. Because a substantial portion of its allocations goes for foreign weapons, military expenditures do little for the country's economy. China needs a better-financed military, but it can ill afford what the generals demand. Yet they will prevail in the country's politicized system.

Fourth, capital flight continues to plague China even after the harsh crackdown by SAFE in 1998. The exact dimensions of the problem are unknown, but discrepancies in national statistics point to a continuing problem.[108] Moreover, unauthorized foreign borrowings by Chinese companies remains at a high level: the discrepancy between official statistics for this category and the figures issued by the Bank for International Settlements is in the neighborhood of US$20 billion.[109] Annual capital flight may be as much as US$45 billion these days, more than four times the amount at the beginning of the last decade.[110] With the prospect of a worsening domestic economy and growing political and social instability, even more currency may flow through China's porous borders to the outside.

Fifth, state enterprises remain under thunderclouds, despite Premier Zhu's declaration that he solved their profitability problems ahead of his three-year deadline announced in 1998. According to a recent IMF working paper, these organizations "are vulnerable to considerable downside risk from even a moderate weakening of their business environment."[111] Ominously, two-thirds of loans to SOEs in 2000 had a maturity of less than one year.[112] The state should recognize what everyone else sees by now: most of these enterprises are essentially unreformable.

Sixth, the Chinese economy suffers from a growing dependence on foreign oil. Without a strategic reserve, it is vulnerable to swings in world prices.[113] And the list of problems goes on and on from the banking crisis to the one involving pensions. Until the nation's leaders solve these difficulties, economic growth will be stunted. In light of all the above, this report forecasts growth for 2002 through 2005 to average 3.5 percent. GDP predictions, contained in Figure 2.5, are well below both the consensus estimates contained above and the numbers that the state itself will report. The failure of the past half decade to address structural deficiencies in the Chinese economy must effect growth in the next few years, and this conclusion is reflected in the estimates. These estimates also reflect upcoming increases in imports and declines in foreign direct investment.

Figure 2.5
Estimated Percentages of GDP Growth
2002-2005

2002	2003	2004	2005
4.1	4.0	3.1	2.7

Despite all the problems that the Chinese economy faces, Zhu Rongji remains decidedly upbeat. "Basically all the tasks have been completed over the past four years," he said at his final press conference, referring to his three main economic goals of creating sustained economic growth, maintaining a stable currency, and making a majority of the state enterprises profitable. "So I think this government has made good on its promises."

Zhu may say what he wants, but he is not going to convince many in the world today because a "severe vicious" circle is developing in China's financial system. Are those the words of some hysterical analyst? No, they come from the Organization for Economic Co-operation and Development. "The biggest risk is a vicious circle in which enterprise, banking, unemployment, and other structural problems either do not improve or get worse, and generate further deflationary pressures on real growth, which in turn make it all the more difficult to make progress on structural problems."[114]

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